

Small Business Notes

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Working Your Passion? Pay Attention to IRS For-Profit Business Definitions

In response to the COVID pandemic, many individuals consider expanding their current personal hobbies and recreational activities into businesses whose revenue can augment or replace current employment income. One apparent benefit of having such a business lies in Internal Revenue Code Section 162 which provides for deductibility of expenses sustained in carrying on a trade or business. Such deductibility for “hobby” activities—even those called a “business” by their owners and holding themselves out for some exchange of goods or services for payment – was removed by the Tax Cuts and Jobs Act of 2017.

To qualify for the deduction now a business must identify as a business “engaged in for profit.” The significant language of IRS Regulation 1.183-2 states, “Although a reasonable *expectation* (emphasis added) of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continues the activity, with the *objective* (emphasis added) of making a profit...greater weight is given to objective facts than the taxpayer’s mere statement of his intent.”

The Regulation continues with nine “relevant factors” that the IRS uses to determine if business activity is engaged in for profit:

1. The manner in which the taxpayer carries on the activity (e.g., having complete and accurate books and records; use of operating methods and techniques consistent with an intent to improve profitability).
2. The expertise of the taxpayer or his advisors (e.g., extensive study of accepted business, economic, and scientific practices or consultation with experts).
3. The time and effort expended by the taxpayer in carrying on the activity (e.g., devoting much personal time and effort to the activity).
4. Expectation that the assets used in the activity may appreciate in value (e.g., the value of resources like land or machinery or processes will appreciate even if no profit is derived from current operations).
5. The success of the taxpayer in carrying on other similar or dissimilar activities (e.g., earlier success in converting unprofitable activities to profitable ones).

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6. The taxpayer's history of income or losses with respect to the activity (e.g., a series of years in which net income was realized would be strong evidence of for profit activity).
7. The amount of occasional profits, if any, which are earned (e.g., the relationship of assets to value may provide useful criteria in determining the taxpayer's intent).
8. The financial status of the taxpayer (e.g., does the taxpayer have substantial sources of income from sources other than the activity that may indicate that the activity is not engaged in for profit).
9. Elements of personal pleasure or recreation (e.g., the presence of personal motives may indicate that an activity is not engaged in for profit).

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